

# China on the Fast Track

*Introduction*

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1992 was a banner year for the Chinese economy. With relatively little world media attention, China achieved a spectacular 12.8 percent output growth rate and at the same time laid the ground for an ambitious economic reform program. The achievements were especially notable in view of the general doldrums in the world economy and the immense difficulties encountered by the formerly socialist economies in Eastern Europe and the former Soviet Union. Impressed by this outstanding performance, some observers predict the rise of China as a world economic super-power in the next century.

This Letter reviews China's rapid growth and rededication to economic reform in 1992 and assesses both the short-run and the long-run prospects of its economy. While generally optimistic about its future, it also calls attention to some major challenges facing China. China's successful take-off to achieve sustainable economic growth into the next century will depend critically on whether it will be able to overcome existing structural weaknesses in its economy.

## **Flying High**

Nothing exhilarates as success, and China's economic performance in 1992 was indeed exhilarating. Its output growth rate accelerated to 12.8 percent from 7.0 percent the year before. The growth was broad-based. Real agricultural output rose 4 percent, and the grain harvest was the second highest on record. Industrial output rose 20 percent, on top of a 14 percent increase in 1991. Most remarkable was the phenomenal 60 percent output growth of rural and township industries, which in 1992 employed a total of 100 million workers and accounted for about 17 percent of the nation's total labor force. Foreign trade also grew rapidly: exports rose by 23 percent and imports increased by 18 percent. Attracted by a booming economy and availability of low-cost labor and land, foreign direct investment reached \$11 billion, more than double the volume in 1991. In addition, amidst this rapid expansion inflation remained moderate: retail prices increased 5.3 percent, up from 4.0 percent the year before.

The boom in 1992 was an acceleration of recovery from a prolonged recession in 1989-90. The recession was brought on by a severe austerity program launched in September 1988 in order to fight inflation. The program was remarkably successful in achieving its goal: the retail price inflation rate fell from 27 percent in 1988 to 6 percent in 1989 and near zero in the second half of 1990. In 1991, the authorities cautiously eased up controls; the economy responded quickly, with output rising 7 percent, up from 4 and 5 percent in 1989 and 1990. Then in 1992, the authorities pulled out all the stops: investment expenditures rose a whopping 33 percent, while the broad-money (M2) growth rate reached an 8-year high of 30 percent. Under these strong stimuli, output growth accelerated to nearly 13 percent, second only to the historical high of 14.6 percent in 1984.

## **Economic Reform**

1992 is also notable because it marks the start of the third stage of China's economic reform--the first two beginning in 1979 and 1984, respectively. The year opened with a clarion call by Deng Xiaoping to accelerate the pace of economic reform. In his celebrated "Speech After the Southern Tour", Deng strongly berated the "obstructionists" who wished to cling to the old system, and called for bold, across-the-board economic reform in order to let market forces play a greater role in a "socialist economy with Chinese characteristics." The speech signaled a major change in the direction of the country's economic policy.

Previously, for three years from 1989 to 1991, reform was put on hold in the name of combating inflation. Since the only policy instrument available to the authorities for fighting inflation was direct controls through the old planning framework, the seat of power in policy making shifted markedly back to the central planning authorities. In that environment, planning control was king, and mere talks of economic reform were taboo.

Deng's speech changed all that. Immediately after the speech, a carefully orchestrated nationwide movement was launched to study the speech, and senior officials and researchers were directed to prepare a comprehensive program for the implementation of the ideas contained in that speech. Suddenly, the atmosphere changed. Reform came back in vogue, and officials at all levels and in all regions began actively pushing for reform.

Some interpret this abrupt change as another demonstration of Deng's undisputed leadership in China. Without disputing the obvious, there is nevertheless another way to look at this remarkable phenomenon.

It is common knowledge that even during the time of tight spending controls in 1989-90, regions in the south--Guangdong Province and the three Special Economic Zones along its coast--were seemingly free to invest and extend credit as much as they wanted. Some attribute this to the local officials' special connections with top officials in Beijing. However, an equally plausible explanation is the regions' close economic integration with neighboring Hong Kong. During 1989-91, while investments from the industrial countries dwindled, those from Hong Kong and Taiwan rose precipitously and concentrated mainly in the southern regions, where the local authorities were highly permissive and accommodative toward both foreign and domestic investors, in contrast to the tight controls in the rest of the country. The special latitude granted to the local authorities in these regions perhaps reflected a recognition of the regions' special role in attracting much needed capital and technology from Hong Kong and Taiwan. In any case, fed by foreign capital inflows, the resultant rapid economic growth and prosperity in these regions became a giant magnet sucking in a large and rising volume of capital and skilled labor from the rest of the country. For the rest of the country, the situation was intolerable. Presumably, rising political pressures from the rest of the country made the policy change inevitable.

Indeed, among the first actions of the policy change was permission granted local authorities across the country to establish "special development zones" with a virtually free hand to offer incentives for attracting domestic or foreign capital to develop local industries. The local authorities wasted no time to avail themselves of this opportunity. The number of such zones jumped from 117 at the end of 1991 to more than 2,000 at the end of 1992. Conceivably, a substantial portion of the 33 percent increase in investment expenditures in 1992 was due to the local governments and the businesses they established.

In the meantime, a comprehensive reform program was drawn up by the State Commission on Restructuring the Economic System. The program was approved and promulgated by the State Council in March this year. As promised, the program was truly bold, aimed at clearing away nearly all the remnants of the old economic structure that continue to impede the working of market forces, in areas ranging from state enterprises, price controls, commodity markets, foreign trade, investment restrictions, government budget and revenue sharing, banking and financial markets, wages, unemployment insurance, housing, and medical care. Reports from China indicate that implementation of parts of the program has already begun: for instance, in the laying off of idle workers in state enterprises.

### **Near-Term Prospects**

The near-term prospects of China's economic growth depend crucially on the authorities' assessment of the risk of inflation currently in the economy. Over the past year, a debate has been raging in China over whether the economy has become "over-heated." Those who are not concerned argue that the rapid growth in 1992 was a natural rebound from the prolonged 1989-91 recession, that the high money and investment growth was to meet pent-up demand, and that in fact the inflation rate measured by retail prices was quite moderate. Those who are concerned point to the more than 11 percent rise in the cost of living index for residents of 35 major cities, the 13 percent rise in the prices of capital goods, and within that index the 16 percent rise of electric machinery prices and the 18 percent rise in cement prices. In addition, they claim, the nation's transportation capacities were already severely strained, meeting only 60 percent of demand. They fear that sooner rather than later the strains felt in the production sectors last year will spill over to affect consumer prices this year.

Recently released data indicate that rapid growth continued into the first quarter of 1993, with output at a level 14 percent higher than the same period last year, industrial output 22 percent higher, investment by state enterprises an astounding 70 percent higher, and that by local governments 80 percent higher. At the same time, signs of accelerating inflation have appeared. Retail prices in major cities were 15 percent higher, and those in the countryside more than 8 percent higher, than last year. The \$1.2 billion trade surplus during the first quarter of 1992 turned into a \$1.2 billion deficit this year.

Under these conditions, reportedly actions have already been taken to restrain inflation: orders have gone out to banks over the country not to exceed allocated credit limits, and many investment projects have been canceled or postponed. If these measures are effectively carried out, an explosive boom-and-bust might be avoided. One would then expect a significant slow-down of output growth from its rapid pace last year, to perhaps 8 percent as in the official forecast. However, in view of the signs of inflationary pressures that have already surfaced, retail prices are likely to rise more than 10 percent for the year, rather than the 6 percent envisaged in the official forecast.

### **Long-Term Prospects**

During the decade of the 1980s, China achieved a remarkably high average growth rate of 9 percent a year. The achievement was attributable to the economic reform since 1979, which has released abundant productive initiative, talents, and energy to seek opportunities for improved standard of living. Given the nation's renewed commitment to economic reform, its high savings rate, its large pool of under-utilized labor, its low level of technology, and the wide areas of structural adjustments yet to be explored, there is every reason to be optimistic about China's long-run growth prospect.

This optimism, however, is predicated on the nation's long-term commitment to economic reform and on the soundness of the reform program. Although economic reform has benefited the vast majority of the people, commitment to reform is a political decision. In every reform there are always winners and losers, and there is no guarantee that the will of the minority losers would not dominate over that of the majority winners—especially in a country like China, where the direction of political winds is particularly hard to predict.

As to the soundness of the reform program, since only its broad outline was made public recently, it is obviously premature to attempt any serious assessment. Nevertheless, from the scope and general thrust of the announced program one does gain an impression of a readiness to depart from the piecemeal approach to reform in the past and replace it with a systems approach that takes into consideration the interlocking relationships of the various parts of the reform program. For instance, the perennially loss-making state enterprises have been a millstone that has weighed down government finance and at the same time obstructed reform of the financial system; reform of the inefficient state enterprises in turn has been impeded by not having a "safety net" to provide housing, medical care and other types of adjustment assistance to workers laid off from these enterprises; and yet to provide this safety net would require funding which presently the government can ill afford, given the poor state of its finance. It appears that a piecemeal approach can no longer meet the present needs of reform. Whether the newly announced comprehensive reform program can break this gridlock remains yet to be seen.

### **Conclusion**

Reform of centrally planned economies is an uncharted territory. Using a piecemeal, experimental approach since 1979, China has attained remarkable success in shedding many of the shackles that had deprived its people of the fruits of modern economic growth, as enjoyed by the peoples of the industrial countries and the newly industrialized economies in the Pacific Basin region. China's growth performance since reform began, and especially in 1992, has been impressive. In the short run, its ability to achieve sustained rapid growth will depend on its success in defusing the current threat of inflation without another recession. In the long run, despite reform, the shackles that remain continue to restrain the nation from exploiting its full growth potentials. The authorities in China appear to have recognized the limitations of the piecemeal approach and now have adopted a bold and broad reform program. The world waits, with interest and good wishes, for its successful outcome.

#### *About the Author*

Dr. Hang-Sheng Cheng retired from his position of Vice President and Director of Center for Pacific Basin Monetary and Economic Studies, Federal Reserve Bank of San Francisco in 1992 while remaining as its Consultant. He received a B.A. in history from Tsing Hua University in China in 1948 and a Ph.D. in economics from Princeton University in 1963. He was a professor of economics at Iowa University and has also taught at the University of California at Berkeley. He was President of the Chinese Economic Association in North America for 1991-92 and is currently President of The 1990 Institute.

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